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As a Japanese scholar once pointed out, the Chinese generally don't trust strangers. As a result, family-run businesses have traditionally dominated the private sector in China. However, that tradition is now being challenged by one private enterprise: Gas appliance manufacturer Guangdong Huadi Group, based in Guangdong, a province in south China.

In 1991, after raising about 1 million RMB (US$125000), four good friends – Deng Xinghua, Huang Wenzhi, Pan Quanzhi and Li Jiakang – faced the challenge of establishing a new industry. By conducting extensive market research, they found that 85% of the gas appliances in the market were currently being made by small factories that had no standards in place. They concluded that this was an industry full of potential. Deng Xinghua, a skilled organizer and coordinator, then invited his high-school friend, Yang Jinhui, to join him. Yang, an expert on gas appliances, also recommended two of his good friends, Huang Qijun and Guan Xiyuan. Both of them were involved in sales at the same company and knew how the market worked. In early 1992, the seven men set up Guandong Huadi Group.

Amid growing demand for gas appliances in China, Huadi's sales and market share steadily rose, it has annual sales of more than 1 billion RMB (US$125 million) and nearly 2000 employees today. At the same time, four of the seven founders of Huadi decided to set up separate supplier operations -- thereby keeping the profits in-house -- and put their relatives in charge. They also restructured Huadi's sales system by establishing nine sales centers in the country. Each sales center amounts to an independent profit center. The investors in the nine sales centers are the other three founders of the company, including Huang Qijun, Guan Xiyuan and Li Jiakang.

For many years, the seven founders divided up their responsibilities among manufacturing, R&D, public relations and human resources. But eventually that kind of management style didn't fit the company's growing needs. On October 28, 1999, they announced a plan to separate the company's management from its ownership. They introduced an outsider, Yao Jiqing, to serve as chief executive.

After taking over the reins, Yao restructured the company's organization chart by combining certain functions like sales, marketing and public relations into one department and also established a new unit to focus on exports. Through a number of different steps, he ended the era of separate responsibilities set up by the seven founders. The results of his reforms were quickly evident. Between 2000 and 2001, for instance, Huadi launched more than 50 new products and significantly improved its production efficiency.

In 2000, Yao broached to the board the idea of going public as soon as possible. The seven founder-board members unanimously agreed. But it was one of the founders, Huang Qijun, who was mainly in charge of the process, not Yao. In 2002, soon after the initial public offering, Yao resigned from his CEO post and left for another company. Huang Qijun then took over that position.

A Matter of Trust

The growth of the Huadi Group has attracted the attention of many scholars. Wang Xuanyu and Li Xingchun at Zhongshan University and Chen Ling at Zhejiang University reviewed and analyzed Huadi's development in a recent article entitled, "Capital Joint-Venture and Trust Expansion—Research on non-family Entrepreneurial Partnership". They pointed out that although the seven founders are not related to one another, they have been working together for 14 years. The question is: How did they form and sustain this kind of trust? And why hasn't the trust among the founders spread to the management level?

The scholars cite three conditions that must be met before a non-family business can take off, they say. First, the founders must have similar backgrounds. The seven Huadi founders, they noted, all knew each other well before they came together for this venture. It's easier to build up trust among friends.

Second, the founders must be very astute about the marketplace. The seven Huadi founders based their decision to venture into the gas appliances industry precisely on their knowledge about the market and their sensitivity toward business opportunities, the scholars pointed out.

Finally, the skills they bring must also be complementary, meaning that each founder can bring to the table his own experience and unique capabilities. At the beginning, after the Huadi founders set their eyes on the gas appliances business, they soon recruited Yang Jianhui, Huang Qijun and Guan Xiyuan because of their different skill sets. The hiring paid off, as evidenced by the company's rapid rise in the first three years, the scholars said.

At the same time, the researchers emphasized that it is the check-and-balance system that ensures this kind of long-term relationship. For instance, the investors in the nine Huadi sales centers are three of the seven founders, while the other four – through their relatives – are in control of the supplier enterprises. "This arrangement ensures a fair distribution of profits among the seven founders, thereby reducing potential conflicts over how to divide up the wealth," the scholars said. They also noted that the founders must share the same goal for the enterprise. The seven Huadi founders have had disagreements over the years, but they all have had one goal, which is to make Huadi the number one appliances brand in China.

Of course the company must be profitable so that the founders feel it is worth their while to work together as opposed to venturing out on their own. Huadi's success has enriched each of its seven founders, the three scholars noted. "Good results can act as a strong economic incentive for them to co-operate while increasing the opportunity cost associated with the seven founders splitting up. The company's financial success is the result of their cooperation and at the same time, the success also incentivizes them to continue to work together."

Finally, there is communication. The seven Huadi founders have maintained their interactions in a very traditional Chinese way. They often get together for lunch, dinner or tea. Each time they are together in a social setting, they share their views and reinforce their friendship. "They act like a family, which can serve as a lubricant to their relationship," the three scholars concluded.

The three scholars also tried to analyze why the CEO hired to run Huadi didn't win the kind of trust shared by the seven founders. The most important reason, they said, is that the CEO was only a temporary solution employed by the founders to soften their disagreements. At Huadi's initial stage, each of the seven founders was responsible for a different area. But as the company grew bigger, that kind of management style began to show its limits. In particular, there was a lack of coordination among the founder-managers to solve their disagreements. That's where a CEO with a neutral position came in. But once the disagreements among the founders were solved, the outsider CEO became unnecessary.

Yao Jiqing didn't sign a contract when he took on the CEO position. Nor did the founders guarantee him any kind of employment terms. Just before Yao left Huadi for another company, he had done a major restructuring aimed at motivating employees. The idea was to make each division a profit center. Those who were viewed as key contributors could get a big share of the profits. "In the eyes of the seven founders, the move implied competition for their shares of the company and of course, they didn't like it," the researchers noted. At the same time, according to the company bylaws, the CEO was expected to stay with the company for three years after the IPO. "That meant if Yao were to stay on as the CEO, the seven founders wouldn't be able to veto any of his reforms."

The researchers quoted in their article a conclusion drawn by one of the Huadi founders, Huang Qijun. "For those Chinese who want to work together, they must be qualified to work together," he said. The scholars interpreted this to mean that to work together to set up a business, those involved must have similar social status and economic background. Their analysis showed that the seven Huadi founders hold equal shares in the company and that their new partner after the IPO – Zhongshan Liandong Investment – injected 15 million yuan into Huadi and accounted for 27% of its ownership. But Yao Jiqing didn't have the money needed to become another partner. Another factor is that Yao himself was too "ambitious," which angered the seven founders. "In simple terms, the founders felt threatened by Yao and by comparison, they felt much safer to have one of them - Huang Qijun - as the CEO," the three scholars concluded.

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